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THE THEORY AND PRACTICE
OF FAIR RETURN:
Rent Controls in Berkeley,
1978 - 1985

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THE THEORY AND PRACTICE OF FAIR RETURN:
RENT CONTROLS IN BERKELEY, 1978 - 1985


A Study by the California Housing Research Institute (CHRI) *

1. INTRODUCTION **

Rent control has been in effect in Berkeley without interruption since mid 1978. Ordinance 5109, known as Measure I ("The Renter Property Tax Relief Ordinance"), passed by the voters in November of 1978, contained a roll-back provision setting legal rents at the levels prevailing on June 6, 1978. When Measure I expired at the end of 1979, it was replaced by Ordinance 5212 ("Temporary Rent Stabilization Program"), passed by the City Council to cover the six-month period until the next elections in June, 1980, during which time permanent controls were to be considered. Measure D, the "Rent Stabilization and Eviction for Good Cause Ordinance" passed in that month, establishing permanent rent and eviction controls. Measure D was amended in June of 1982 by Measure G (the "Tenants Rights Amendments Act of 1982) and in November of 1982 by Measure N ("Elected Rent

* A description of CHRI, including authorship credits, appears at the end of this paper.

** Footnotes are hereafter identified by numbers in brackets, and can be found at the end of the paper.



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Stabilization Board"). There is no sunset provision in the current ordinance, as amended.

Throughout this six-and-one-half-year period of rent control in Berkeley, there have been continuing debates about the fairness of the controlled rents. The debate has followed somewhat different courses in its political, administrative, and judicial settings. Politically, there are two relevant groups in Berkeley: some 4,000 property owners - many convinced that their property is being taken by a policy and program which does not allow them reasonable rent increases in years of high inflation - stand opposed to 51,428 tenants, the occupants of 27,821 rental units, many of whom are equally convinced that all or most rent increases are unwarranted and that tenants as a class are exploited by owners who charge unnecessarily high rents and make unnecessary profits in housing. Periodically the voters are asked to ratify or amend the rent control legislation, and such requests have been granted in recent years by substantial tenant majorities.

Administratively, there has been little progress on the question of the fairness of controlled rents since the regulations were written in 1980 and 1981. The basic fair return provision of the Ordinance itself - "... the regulations shall [not] be applied so as to prohibit [an owner's achievement of] ... a fair return on investment" - is included verbatim in the regulations.[1] But the same regulations spell out a system for setting maximum rent levels - the Maintenance of Net Operating Income (MNOI) system - which has major deficiencies from a fair return point of view.[2] The Rent Stabilization Board in

mid 1981, recognizing the inadequacies of the MNOI system, wrote in Regulation 1275 that the MNOI system would be used by the Board "until such time as the Board adopts regulations setting forth specific guidelines to be used in determining the rent ... which would provide the [owner] ... with a fair return on investment ..." No substantial progress has been made on this question by the Board or its staff since that time. In fact, the Board had as late as January, 1985 no active program of research which would have the result of establishing a genuine fair return standard, having rejected proposals for such study in each of several previous years.

Judicially, the debate has centered on the question of "fair return" under rent controls, and the California courts have made steady progress during this six year period on the definition of fair return in the rent control context.[3] The Birkenfeld decision of the Supreme Court of California in 1976 set the stage for all subsequent legal deliberations by declaring invalid a 1972 rent control charter amendment while affirming the right of municipalities to establish rent controls. The decision established that rent controls are legitimate applications of the police power "if they are reasonably calculated to ... provide [owners] ... with a just and reasonable return on their property", but that "such a regulation may be invalid on its face when its terms will not permit those who administer it to avoid confiscatory results." [4]

Subsequent decisions have further clarified the meaning of "just and reasonable", "return on property", and "confiscatory results". A

central question has been what the Birkenfeld Court meant by "... a just and reasonable return on their property." Owners have insisted that the current market value of property must be considered to avoid confiscation. Rent control jurisdictions have countered that "return on investment" is sufficient. *Baker v. City of Santa Monica* established that limiting return to return on the original cash investment is confiscatory. In Oceanside, the Supreme Court established that return on property (or market) value, on the other hand, is not required, and that the "fair net operating income" approach, with adjustments for inflation, is adequate to the avoidance of confiscation, allowing controlling jurisdictions to grant rent increases ensuring a just and reasonable return.[5] In Cotati, the Court of Appeals further defined the meaning of "return on investment", interpreting "fair and reasonable return on their property" in Birkenfeld to mean that owners must be granted rents adequate to cover all expenses, including interest on property-related debt, and in addition a fair return on the current value of all investment in the property, taking inflation into account.[6] Finally the Fisher decision has recently confirmed the facial validity of rent control ordinances which allow the regulatory authority to grant rent increases and to set rents which provide a fair return on investment in the Cotati sense.[7]

It is the purpose of this paper to assess the six-year record of rent control in Berkeley in terms of the fair return outcome for property owners, this being the standard by which the courts have and will presumably judge the law as applied. We will ask whether average rent

levels are "fair and reasonable" and whether rent increases are "warranted" or "excessive". We will estimate the percentage of owners who receive a fair return today. Most important, we will ask whether available administrative procedures are adequate to the task - assigned by the Ordinance, by the Supreme Court, and by the Constitution - of ensuring a fair return.

2. BERKELEY'S CONTROLLED RENT

In this section we explore the rent adjustment process under the current and preceding rent control laws in Berkeley and estimate the rent level outcomes for complying owners.

2.1. Rents Under Measure I. When the first of the current series of ordinances was passed in November of 1978, rents were rolled back to their levels on the preceding June 6, and were frozen for the remainder of that year. Then, on 1/1/79, it was required that rents be decreased by an amount representing 80% of the Proposition 13 tax reduction. No general increases were allowed under the ordinance, but individual owners could increase rents to cover certain cost increases, including increased costs of property related debt service and certain types of capital improvements, properly amortized. Owners could take this increase upon supplying tenants with a "clear financial statement which explain[ed] and document[ed] the increased costs which necessitate[d] the rent increase." [8]

The percentage of owners taking advantage of Measure I's rent increase

provisions is unknown. However, we can reconstruct what would have been possible in that year for a complying owner, using data from a 1983 Rand Report on California's Housing.[9] Property taxes fell on average 59% between the 1977-78 and 1978-79 tax years.[10] Property taxes were in 1977 20% of expenses for an average property.[11] Expenses being approximately 40% of gross rent [12], the tax reduction was approximately 4.7% of rents, and the required rent reduction was 3.8% of gross revenue. Accordingly, rents should have decreased in January of 1979 by an average of 3.8%.[13]

Meanwhile, costs were increasing at that time, as shown in Table I on the following page. Expenses other than taxes between 1978 and 1979 increased by 10%. These expenses being 32% of rents, an average owner who did not incur increased costs of debt service or capital improvements would have experienced cost increases of 3.2%. Allowing for the return to tenants of the remaining 20% of the tax reduction, a complying owner would have been allowed at that time a rent increase of roughly 2.3%. The net change in rents for an average property owner during Measure I (mid-1978 through 1979) would then have been negative 1.5%.

In what follows, we take this figure as the average net change of rents during the Measure I period. The assumptions underlying this step are somewhat problematic, however, and it would be far preferable to have survey data accurately recording what increases and decreases actually occurred. On the one hand, there were a number of sales of property in that year, and debt service cost increases were allowed at

TABLE 1

1978-79 COST INCREASES (OTHER THAN PROPERTY TAXES)

	<u>Weight</u>	<u>Rate</u>	<u>Increase</u>
Insurance	.06	.20	.012
Maintenance:			
Commodities	.24	.085	.020
Services	.27	.105	.028
Fuel	.01	.32	.003
Electricity	.05	.098	.005
Gas	.08	.148	.012
Water/Sewer	.05	.05	.003
Management	.15	.077	.012
Building Services	<u>.08</u>	.054	<u>.004</u>
	.99		.099

Source: Rand, Op.Cit., Tables C7, C8.

that time, so that some increases were undoubtedly much higher than the average computed. On the other hand, it is apparent that many owners were unable or unwilling to go through the fairly complex calculations required by the ordinance and therefore simply left their rents unchanged, giving neither the required decrease nor the allowed increase. The rent structures of such owners are now very much at risk, since the Board takes the position that tacit off-sets of this type constitute non-compliance. Under Measure G, all subsequent increases are in such a case forfeit forever.

In addition, although Measure I did not elaborate on the "clear financial statement" owners were required to give tenants, and although there was at that time no agency of government prepared to advise owners on the form or content of the statements, hearing examiners are today at liberty to pronounce the statements inadequate for a wide variety of reasons and have done so with regularity, reducing rents to their 1978 levels less the required property tax reduction. For this reason, an increasing number of units in Berkeley which did have "Measure I increases" are today losing them retroactively, with full refund of "overcharged" amounts to present and former tenants.

2.2. Rents Under Ordinance 5212. Rents under the second of Berkeley's recent rent control ordinances were frozen for the first half of 1980, but owners could take an increase of up to 5% to cover cost increases "actually paid after ... [12/30/79]," subject, as under Measure I, to the provision to tenants of a "clear financial statement

which explains and documents the increased costs which necessitate the rent increase." [14] Rents were again frozen on 5/31/80 by the passage of Measure D. Debt Service cost increases were not allowed under Ordinance 5212.

The percentage of owners that took an Ordinance 5212 increase, like the percentage that took the Measure I increase, is unknown. It would be far better if we had reliable survey data. But, as before, we can proceed by assumption as follows. An estimate of the cost increases between 1979 and 1980 is 12%. (See Table II on the following page.) Taking expenses as 40% of gross rent (see footnote 12), we estimate that expense increases represented in that year 4.8% of gross rents. But the allowed increase was for "cost increases actually paid" after 12/30/79 and before 5/31/85, and therefore but 5/12 of the annual increase would, on average, have "actually been paid" while the increase was allowable. Since 30 days notice to tenants was also required, the effective cut-off date was 4/30/80, and the effective ratio 4/12. Since capital improvement expenses had to be incurred during 1980 and since the 30-day notice applied, it appears highly unlikely that more than a handful of owners were able to take advantage of that provision, particularly considering that only those capital improvements undertaken with prior consent of tenants or to bring the property up to code were allowable. This being so, the maximum increase an average complying owner could have legally claimed would have been approximately 1.6%. [14a]

We use this figure in what follows as the average allowable 1980 rent

TABLE II
1979-80 COST INCREASES

	<u>Weight</u>	<u>Rate</u>	<u>Increase</u>
Taxes	.096 *	.07 **	.007
Insurance	.060	.03	.002
Maintenance:			
Commodities	.224	.11	.025
Services	.242	.12	.029
Fuel	.016	.42	.007
Electricity	.049	.16	.008
Gas	.067	.21	.014
Water/Sewer	.044	.06	.003
Management	.141	.10	.014
Building Services	<u>.071</u>	.12	<u>.009</u>
	1.010		.118

* Adjusted from Pre-1979 weight by dropping by 59%

** 2% increase in property taxes plus library tax increase of 5%

SOURCE: RAND, op. cit., Table C-7

increase. It represents, we believe, the best available estimate. It may be far from accurate, however, for the following reasons. Measure I, in Section 13, said that owners could take after 1/1/80 a five percent (5%) increase without documentation of any kind (documentation being required for increases greater than 5%). Ordinance 5212, passed by the City Council on the eve of the new year, maintained the 5% figure, but changed the documentation requirements such that no increase could be taken without documentation. Anecdotal evidence suggests that many owners, following what they understood to be a general increase without documentation requirements, took the 5% rent increase in early 1980 without producing and delivering to tenants the required financial statement. For this reason it is possible that the average increase for 1980, if it were known, would exceed 1.6%. On the other hand, hearing examiners today regularly order refunds and roll-backs in such cases. Lack of a proper financial statement from that period is taken as per se evidence of non-compliance with the law, and all "overcharges" generated in this way are ordered returned to tenants, with permanent forfeiture of all subsequent, otherwise legal, rent increases to the date of hearing. For this reason an increasing numbers of owners who did take a 5% increase in 1980 are losing that increase retroactively, and it may turn out that the 1.6% estimate is in fact too high.

2.3. Rent Increases Under Measure D and G. Measure D, as amended, a more complex rent control scheme than its predecessors, allows rent increases in two ways. All owners are allowed to take,

without any documentation, an annual increase intended by the Ordinance to approximate the average increase in operating and maintenance expenses in the past year - an Annual General Adjustment (AGA). Individual owners are permitted to apply to the Board, with extensive documentation, for an Individual Rent Adjustment (IRA) if they feel that the AGA's have not allowed sufficient increases.

The AGA's are achieved by a political process, based on public input as well as expert testimony. This process culminates in the fall of each year in a vote of the Board, usually taken midst considerable enthusiastic clamor by the affected sectors of the population. The main expert analysis during the past three years has been provided by Board consultant Ken Baar. His reports are discussed below. The Board's freedom in making the AGA decision each year is restricted by a provision of Measure G stating that adoption of an AGA greater than 45% of the CPI for the previous year requires the affirmative vote of 6 of 9 commissioners, and by certain provisions of Section 11 of the Ordinance which according to a ruling by the City Attorney prevent the Board from considering the effects of inflation on owners' net operating incomes in establishing the AGA.[15]

The AGA's are intended by the Ordinance to compensate owners for actual cost increases, but not for the effects of inflation (loss of purchasing power) on owners' incomes. The accuracy with which this intention has been achieved in past years is explored in Section 3 below. The AGA's allowed by the Board in the five years of Measure D/G are as follows: [16]

1980	0
1981	5% (6.2%)
1982	9%
1983	4.75% (5.0%)
1984	0
1985	2%

These figures are used in the following analysis of controlled rents in computing an estimate of average rents of complying owners who have not applied for an IRA. There is an element of doubt in the use of these figures, however, that should be mentioned at this point.

Measure G states that owners who are not in compliance with the current or preceding rent laws may not take, and forfeit forever the right to take, the Annual General Adjustment for the year of imperfect compliance. The Board's hearing examiners and appeals panels are consistently taking the position that any deficiency automatically triggers this penalty, whether material or insignificant. Thus an accounting error in any year's rent adjustment will mean the loss of that and subsequent AGA's. Lack of or "insufficiency" of a Measure I or Ordinance 5212 financial statement will have the same result. Likewise, if the registration documents filed with the Board for any year since 1979 are to any degree incomplete, registration will be deemed "improper" and the right to all AGA's will be retroactively denied, with refunds of overcharged amounts.

For these reasons, a growing number of owners have found their rents returned to pre-1978 levels by the hearings process. Since the City

is taking the position that no statute of limitations applies to acts of the Board, this practice can presumably continue forever.[17] At the present time the fraction of owners who have experienced such a roll-back is relatively small (roughly 300 properties out of a total of 6,000), but the numbers are growing daily, and must effect an accurate judgment of legal rents in Berkeley.[18] At this time we have no accurate statistical basis to judge the overall impact of roll-backs, and therefore leave them out of the estimates. Were they included, these considerations would clearly demand a lower overall estimate of average legal rents than we compute in Section 2.6 below.

2.4. Staff and Consultant Studies Supporting the AGA's. In each of the years since 1980, when the AGA Committee of the Board studied applicable cost increases for the 1981 AGA on its own, there has been some professional input to the AGA's. In 1981 the California Public Interest Research Group at the University of California performed a study for the 1982 AGA, which supplemented estimates made by the AGA Committee. In each of the three years since 1981 attorney Ken Baar has coordinated studies and made recommendations for the AGA. The staff of the Board and the AGA Committee have typically summarized and interpreted the Baar reports, but have not done independent analysis.

There exists no independent analysis of cost increases in Berkeley with which to make a comprehensive judgment of the accuracy of the expert advice given the Board over the past five years. CHRI has,

however, collected data from various sources which suggest that the official estimates available to the Board have consistently under-estimated cost increases actually experienced by average owners.

The CalPIRG report of 1981, for example, calculated owners' cost increases between 1980 and 1981 at 9.5%.[19] The Rand Report gives data for all of California which estimates cost increases during the same year at 12%. See Table III on the following page. We do not know whether or not there existed a major difference between Berkeley and the rest of California in 1980 and 1981, but it appears unlikely. The San Francisco/Oakland SMSA has had in recent years a higher rate of price increase than California as a whole. The S.F./Oakland CPI-U was increasing at an annual rate of 14.7% between August 1980 and August 1981. For these reasons, CHRI is more inclined to accept the Rand estimate than the CalPIRG estimate. Accordingly, it is assumed in the calculations below for the CHRI estimate of rents compensating owners for cost increases and of Fisher/Cotati fair return rents that owners' operating and maintenance costs increased between 1980 and 1981 by 12%, and that maintenance of the 1979 dollar amount of net operating income would therefore have required in that year a rent increase of 4.8%.

The Baar reports for the next three years involve detailed analysis of many separate cost increases. This is not the place for a thorough evaluation of the details of those reports, and CHRI has not yet done an exhaustive independent analysis of owners' cost increases during

TABLE III
1980-81 COST INCREASES

	<u>Weight</u>	<u>Rate</u>	<u>Increase</u>
Taxes	.091	.02	.002
Insurance	.055	.09	.005
Maintenance: Commodities	.221	.078	.017
Services	.240	.11	.026
Fuel	.020	.22	.004
Electricity	.051	.11	.006
Gas	.072	.14	.010
Water/Sewer	.042	.12	.005
Management	.137	.076	.010
Building Services	<u>.071</u>	.05	<u>.034</u>
	1.000		.119

SOURCE: RAND, op. cit., Table C-7

this period.[20] Unfortunately, the Rand estimates do not continue beyond 1982. Nevertheless, some judgments can be made. Looking at the Baar Reports' cumulative estimate covering three years of cost increases, we find that Baar's estimate is that owners operating and maintenance costs increased by 11.25% between mid-1981 and mid-1984. The CPI-U for S.F./Oakland increased during this period by 16.2%. A study by Ira Lowry of the Rand Institute [21] has established that operating costs of rental housing elsewhere in the U.S. increased over the two decades between 1960 and 1980 by 30% more than the increase in the CPI for U.S. cities over that period.[22] There is no obvious reason for this pattern to be different in Berkeley or for the pattern to have changed since 1980. In addition, a small not-random sample for which CHRI happens to have accurate data shows cost increases during these three years of 18% and 32% for two owners of a total of fourteen buildings. Further, we do know that the Baar estimates omit completely consideration of the Assessment District tax which the City of Berkeley imposed in 1983. This addition alone added 3.3% to an average owner's expenses. It would appear that the Baar Report analyses may suffer from consistent downward bias.

In the absence of accurate alternative data from which to draw an independent estimate, CHRI has chosen to use the Baar figures for 1982 and 1984 and to adjust the 1983 Baar figure by adding an amount to account for the assessment district tax. We are confident that the result is a low-side estimate of actual cost increases during these three years. The estimates adjusted in this way appear below in our estimates of cumulative cost-compensating and fair return granting

rents in 1982, 1983, and 1984.

2.5. Individual Rent Adjustments in Berkeley. The Regulations permit owners to petition for individual increases on a number of grounds: an increased allowed number of tenants in a unit, completed or planned capital improvements, lack of rent increases between 1976 and 1979, increased costs of operation and maintenance, and increased costs of debt service for owners who purchased or refinanced under Measure I or Ordinance 5212. All of these are dominated, however, by the underlying rule that owners may maintain no more than the nominal value of the net operating income achieved in the base year, calendar 1979.

The Maintenance of Net Operating Income (MNOI) standard allows owners the same net operating income today as was received in 1979. Computation is as follows: gross rents in 1979 less expenses in 1979 equals base year net operating income. If current year income less current year expenses is less than base year net operating income, a rent increase is granted. Conversely, if current year income less current year expenses is more than base year net operating income, a rent decrease is ordered. If there are legitimate debt service or capital improvements cost increases, but net operating income before such costs has also increased, these cost increases are off-set against the increase in net operating income, so that the net operating income of 1979 is just maintained in future periods.

The Ordinance itself implies that the Board must grant rent adjustments allowing owners a fair return on investment, making no mention of the maintenance of net operating income.[23] The MN01 system has been adopted in Berkeley and a number of other rent control jurisdictions in California and elsewhere [23a] because it is based on available information, is relatively simple to compute reliably, and avoids a number of computational difficulties found intervals encountered in using other methods.[24] The system is seriously flawed, however, for two reasons: first, because it allows for no adjustment to account for the effects of inflation on owners' net operating income, and second, because there are no exceptions to the heroic assumption that the net operating income received in 1979 constituted a fair return.

The failure to account for the effects of inflation means that owners' net operating income decreases in real value by the inflation rate each year. This being so, the purchasing power of an average owner's net incomes in January, 1985 is 38.4% below what it was in 1979.[25] As inflation continues, real incomes of owners will continue to decline.

It may be noted that there is consistency in application between the two controlling sections of Berkeley's regulations (Sections 11 and 12). Both the Annual General Adjustments and the Individual Rent Adjustments are designed to compensate owners for actual cost increases, but to limit net operating income to the same dollar amount achieved in 1979. For this reason, owners who experience unusually

high cost increases and who therefore apply for an IRA will presumably be thereafter in a financial position entirely similar to other others who did not experience unusually high cost increases and relied simply on the AGA's. Both groups of owners will at most maintain the dollar amount of their 1979 net operating income. Petitioning for a fair return will at most therefore result in an owner's being granted what average owners will gain simply though taking the AGA's. The Board has no procedures for granting rent increases to restore the purchasing power of owners' incomes when that erosion is caused by inflation.

The courts have recently taken note of this problem. In Cotati, the Court of Appeals said "If the net operating profit of a landlord continues to be the identical number of dollars, there is in time a real diminution to the landlord which eventually becomes confiscatory." [26] The Supreme Court in Fisher echoed this view, saying that a rent control ordinance "...may not indefinitely freeze the dollar amount of ... [net operating income] without eventually causing confiscatory results." [27] Nevertheless, neither the Cotati nor the Fisher court examined Berkeley's fair return standards, and therefore Berkeley's practice continues without change as of this writing.

The second major failing of the MNOI system involves the assumption that the net operating income achieved by all owners in 1979 amounted to a fair return. [28] The argument in favor of this assumption is that 1978 rents were freely set by owners, and that they would

logically be set at their fair market value. The argument against this assumption is simply that for a variety of reasons, owners may not have raised rents in the first half of 1978 or in the recent years before that date and may have been "caught" in 1978 with low rents.

Regulation 1262 does provide for the "adjustment" of the base year net operating income in certain cases, but the clause is honored in the breach. In practice, the Board has not allowed owners to adjust base year net operating incomes except in a very few specific fact situations. For example, if a unit was rented to a relative at an especially low rate, the Board might use Regulation 1262 to grant a base year NOI adjustment. But if a unit was rented to an unrelated individual at a low rate because, for instance, of unwise management practices, the Board would most certainly not grant such an increase.[29] There exists, in fact, a lengthy memorandum from the City Attorney on this question which establishes that it is not permissible under the Ordinance for the Board to grant rent increases simply because the rents are low.[30]

The failing in this instance is that the Board has no objective method of knowing whether a particular rent is high, low or correct. The Board's only method, described above as the MNOI method, relies simply on the historical rent levels to prove compliance with the fair return principle. Presumed to be correct in a fair return sense in 1979, rents under Berkeley's ordinance may increase only by enough to cover cost increases.

2.6. Rents Under Rent Control in Berkeley, 1978 - 1985. From the analysis above, we are able to judge the growth of average legal rents in Berkeley. There was a negative 1.5% change under Measure I in 1979, growth of 1.6% under Ordinance 5212 in 1980, and since then we take the rent increases awarded by the Board under Measure D/G: 5% in 1981, 9% in 1982, 4.75% in 1983, zero in 1984, and 2% in 1985. Cumulatively, Berkeley's rent laws have allowed an average complying owner's legal rent to increase from 1978 to 1985 by 22.4%.[31]

3. ASSESSING THE FAIRNESS OF CONTROLLED RENTS IN BERKELEY

There is as of this writing no single standard by which we can reliably judge whether uncontrolled rent increases are "warranted", or whether controlled rents are "reasonable" and provide owners with a fair return. It is instructive, however, to compare the rents allowed under rent control in Berkeley to free market rents elsewhere in the Bay Area, to average incomes of Bay Area tenants, and to the San Francisco/Oakland CPI. We also judge the cumulative recommendations of the experts who have advised the Board over the years. Finally, we compare Berkeley's controlled rents to those which might meet the Fisher/Cotati fair return standard recently elaborated by the courts.

In this Section we refer to Table IV, appearing as Table IV.a. and IV.b. Each column in this table is broken into two parts: the figures on the right are the actual or estimated increases for each year; the figures on the left give an index, in each case adjusted to 1978 = 100 to facilitate comparisons between columns. The index

TABLE IV.b.
SUMMARY OF RESULTS *

	5		6		7	
	<u>CHRI Estimate</u>		<u>Baar Reports</u>		<u>Controlled Rent</u>	
1978	100		100		100	
1979	98.5	-1.5	98.5	-1.5	98.5	-1.5
1980	103.2	4.8	100.1	1.6	100.1	1.6
1981	108.2	4.8	103.9	3.8	105.1	5.0
1982	112.9	4.3	108.3	4.3	114.5	9.0
1983	115.8	2.6	109.8	1.3	120.0	4.75
1984	118.4	2.3	112.3	2.3	120.0	- 0 -
1985					122.4	2.0

* See text for explanatory notes.

TABLE IV.a.
SUMMARY OF RESULTS *

	1		2		3		4	
	<u>CPI</u>		<u>SMSA</u>	<u>Rents</u>	<u>Incomes</u>		<u>Fisher/Cotati</u>	
1978	100		100		100		100	
1979	108.5	8.5	107.3	7.3	108.0	8.0	103.6	3.6
1980	125.0	15.2	120.8	12.6	119.0	10.2	118.0	13.9
1981	141.0	12.8	133.1	10.2	131.6	10.6	132.8	12.5
1982	151.6	7.5	145.9	9.6	142.2	8.1	144.4	8.8
1983	152.8	0.8	160.3	9.9	150.3	5.7	148.9	3.1
1984	162.0	6.0	173.9	8.5	155.7	3.6	158.0	6.1
1985								

* See text for explanatory notes.

Table IV
RENT CONTROL AND PRICE INFLATION: BERKELEY, 1978-85

Year	Controlled Rents	Rent Increases Needed to Offset Increased Operating Costs		Rent Increases Needed to Maintain Real Value of NOI	Actual Rents, SF-Oak S&SA	Consumer Price Index
		Estimated by Baar	Estimated by CHRI			
Rent or Price Index, 1978 = 100						
1978	100.0	100.0	100.0	100.0	103.0	102.0
1979	98.5	98.5	98.5	103.6	107.3	100.5
1980	100.1	100.1	103.2	118.0	120.8	125.8
1981	105.1	103.9	108.2	132.8	133.1	141.8
1982	114.5	108.3	112.9	148.9	160.3	152.8
1983	120.0	109.8	115.8	148.9	160.3	152.8
1984	120.0	112.3	118.4	158.0	174.6	162.4
1985	122.4	(a)	(a)	(a)	(a)	(a)
Annual Percentage Change						
1978	--	--	--	--	--	--
1979	-1.5	-1.5	-1.5	3.6	7.3	8.5
1980	1.6	1.6	4.8	13.9	12.6	15.2
1981	5.0	3.8	4.8	12.5	10.2	12.8
1982	8.9	4.2	4.3	12.1	20.4	8.4
1983	4.8	1.4	2.6	0.0	0.0	0.0
1984	0.0	2.3	2.2	6.1	8.9	6.3
1985	2.0	(a)	(a)	(a)	(a)	(a)

SOURCES:

NOTE: Series from different sources have been restated in index form using 1978 as the base year. See text for details on sources and derivations.

(a) Not yet available.

number at any point, less 100, gives the cumulative percent increase since 1978. For example, taking column 1 in Table IV.a., the entry 162.4 indicates that the S.F./Oakland CPI increased by 62.4% between 1978 and 1984. This figure will equal the sum of the year-by-year increases when compounding is taken into account.

3.1. Comparison to the CPI. A crude but useful guide to the reasonableness of rent increases exists in the Consumer Price Index. Relative prices change over time, and therefore the CPI cannot predict price movements in any single commodity or service over long periods. But for a complex item such as "housing services", in effect a bundle of goods and services from various sectors of the economy, the CPI may in fact predict price increases over short periods with considerable accuracy. It is certainly true that the CPI tracks rent increases in California as a whole over the two decades of the 1960's and 1970's. The Rand Report cites for California as a whole a CPI increase between 1970 and 1982 of 158.2% and a rent increase for the same period of 171.2%.[32] In the San Francisco/Oakland SMSA, prices between 1960 and 1980 increased by 144% and rents over the same twenty years increased by 160%.

Column 1 in Table IV.a., labled "CPI", shows the growth in the Consumer Price Index (CPI-U for San Francisco/Oakland SMSA) during the period of rent control in Berkeley. All figures are from various issues of the Bureau of Labor Statistics News, adjusted to base year 1978. Figures used are the average annual figures released each February for the preceding year. This column shows that the CPI

increased over the relevant period by 62.4%.

Column 7, Table IV.b., labeled "Controlled Rent", shows the growth in rents in Berkeley under Measure D/G and the preceding two laws. By our best estimate, rents during this period have increased by just 20%. With the 2% increase allowed for 1985, rents will during the current year increase by a cumulative total of 22.4% from their 1978 levels.

Thus although rents in California and in the San Francisco/Oakland area generally have kept pace with prices in recent periods, controlled rents in Berkeley have fallen dramatically below the price level. This means that controlled rents have fallen in real value over the period. Tenants, in other words, have rents in Berkeley today which are 25% less expensive in real terms than they were before rent controls began in 1978. Conversely, owners receive rents which, in real terms, are worth 25% less than the rents they received in 1978.[33]

3.2. Comparison to SMSA Rents. Another useful comparison is between controlled rents in Berkeley and uncontrolled (or less strictly controlled) rents in the entire San Francisco/Oakland area. Column 2, Table IV.a., compiled from various issues of the BLS News over the relevant period (recomputed for base 100 in 1978) gives the annual S.F./Oakland CPI figures and the percent increases for each year. The figures show that rents in the Bay Area increased by 73.9% over the six years of rent control, while controlled rents in Berkeley

alone increased by 20%. Since Berkeley is a part of the area-wide statistic, the difference between Berkeley and the rest of the area is still greater.

3.3. Comparison to SMSA Wages. Column 3 of Table IV.a. gives an index of incomes for the relevant period. A BLS income series for the western states was used since a good series for the SMSA or for Berkeley itself does not exist. We make the rough assumption that incomes in Berkeley grew at the same rate as incomes in the western states. The table shows that incomes over the period of rent control in Berkeley grew by 55.7%. Meanwhile, Berkeley's rents grew by 20%. In income terms, rents became 23% cheaper over these six years of rent control. If rent was 33% of income at the beginning, it has fallen by 1985 to 25.7%. Tenants, in other words, were substantially better off after six years of rent control than they were at the beginning of the period.

3.4. Comparison to Fisher/Cotati Fair Return Rents. Probably the most important test is to judge how well Berkeley's controlled rents match rents which would meet the Fisher/Cotati fair return test. Both of those decisions make it clear that rent control schemes which allow no consideration to be taken of the effects of inflation on the value of owners' incomes are confiscatory.[36] CHRI has therefore computed Column 4, Table IVa, titled "Fisher/Cotati", in the following way. We have added to the CHRI estimate of rent increases which compensate owners for cost increases an amount for each year which would compensate owners for the loss of value in net operating income.

The result gives a series of rent levels which we believe would meet the court's fair return standard. Column 4 shows that fair return rent levels would have had to increase by 58% over the six year period. It is interesting that this figure parallels the CPI increase (62.4%) closely. It is also interesting that this fair return figure is not far from the SMSA rent index (73.9%).

3.5. Comparison to MNOI Rents. It is the intent of the Annual General Adjustments in Berkeley, as it is the intent of the MNOI system for individual rent adjustments, to compensate owners for cost increases. A natural question that arises is: how well have controlled rent increases met this objective? The answer is clearly that controlled rent increases have paralleled cost increases remarkably closely. Column 5 of Table IV.b. gives CHRI's estimate of rents which would compensate owners for cost increases.[34] Cost increases would have been covered by a cumulative increase of 18.4%. In fact (Column 7), the Board has allowed cumulative increases over the same period of 20%.

3.6. Cummulative Evaluation of Rents Recommended by the Baar Reports. A related question is how well the experts chosen to advise the Board on the AGA's have performed. CHRI's figures suggest that the Baar Reports and previous expert opinion have consistently underestimated cost increases, recommending a 12% increase over the six years when in fact an 18% increase was justified by the cost-compensation principle.[35]

4. CONCLUSIONS.

CHRI's analysis of controlled rents in Berkeley demonstrate that these rents have, on average, compensated owners for actual out-of-pocket cost increases during the six years of rent control, but that owners have suffered a substantial decrease in the real value of net operating income. This is so because net operating incomes have, on average, remained constant in actual dollar amounts from 1978 to 1984 while inflation has mounted by some 62%. As a result, the real (purchasing power) value of net operating income has declined significantly over the period.

The analysis also demonstrates that Berkeley's rents have increased significantly more slowly than other rents in the Bay Area, and that controlled rents in Berkeley have increased by less than the local price index. The difference between Berkeley's rent increases and local price increases means that in real terms rental units in Berkeley have become 25% less expensive between 1978 and 1984. Similarly, rents grew by less than incomes grew, so that the percent of income devoted to rent dropped, on average, by something like 23%.

It is also clear that Berkeley's controlled rents fall far short of the fair return standard outlined in recent court decisions. By failing to provide any compensation for owner's loss of real value of net operating income, the Board is systematically denying to all owners in Berkeley a fair return on their investments, and systematically enforcing rent levels which, in the words of the court,

"will eventually cause confiscatory results".[37]

It is therefore CHRI's judgment that a very small percentage of owners are receiving a fair return in 1985. For 1985 returns to be fair, 1978 returns would have had to be substantially in excess of fair return levels, and there is no indication in the record that this was so. Any owner receiving precisely a fair return in 1979 - an assumption made by the regulations - cannot be receiving a fair return today. The great majority of Berkeley's owners are therefore deprived of a fair return by the ordinance as applied.

A related conclusion is that although the ordinance itself can be construed as permitting fair return rents, the regulations systematically deny a fair return. The administrative standards now in use are simply inadequate to the task of assigning fair return rents.

There was also in 1982 a 1% per year "bonus" for deferral of the AGA. The 1983 AGA was 4.75% for all owners, but 5% for owners who supplied any common electricity or gas to the building or space heating to individual units. The 1984 AGA was zero. The 1985 AGA was a flat 2% for all owners.

[17] Memorandum dated 10/19/84 from Natalie West, City Attorney, to Jacqueline Foster, Rent Board Program Chief, titled "Statute of Limitations Applicable to Rent Stabilization Board Proceedings under the Rent Stabilization Ordinance".

[18] CHRI has currently underway a study of refunds and roll-backs ordered by the Board since May of 1980. A preliminary result estimates that the total amount of refunds ordered exceeds \$500,000.

[19] Table II, page 6, CalPIRG Research Report titled "The 1982 Berkeley General Adjustment of Rent Ceilings".

[20] Other apparent errors of the Baar reports include the following: The report for 1983 cited an increase in gas prices of 18%, while PG&E has confirmed that the actual increase was 34%. Over the three year period Baar cited a cumulative increase (taking into account a decrease in 1982) of 10%, whereas PG&E cites an increase over the same period of 54%. The weight for Maintenance & Repairs was reduced in the 1983 study from .20 to .14, but the weights for other items in the total were not recalculated. Similarly, the weight for costs of management was (somewhat arbitrarily) dropped in 1984 without re-calculation of the weights. As a consequence, Baar's reports cumulatively show a highly unlikely result, that the operating ratio for average owners has been decreasing steadily, from 43.7% in 1982 to 39.6% in 1983 and to 38.6% in 1984. Quite the opposite is likely to be true: operating ratios are rising under rent controls. If the operating ratio was indeed 43.7% at the beginning of the period, it would, by correct re-calculation of the weights, be close to 50% in 1985.

[21] Ira S. Lowry, "Inflation Indexes for Rental Housing", The Rand Corporation, January 1982.

[22] The U.S. CPI rose from 88.7 to 246.8 over the period, an increase of 178%. Meanwhile, expenses rose from 80.5 to 266.8, an increase of 231%.

[23] Section 12.i.: "No provision of this Ordinance shall be applied so as to prohibit the Board from granting an individual rent adjustment that is demonstrated necessary by the landlord to provide the landlord with a fair return on investment."

[23a] See Baar, "Guidelines for Drafting Rent Control Laws: Lessons of a Decade" (1983), 35 Rutgers Law Review 723.

[24] The return on value system, much discussed in court decisions,

FOOTNOTES

- [1] Rent Stabilization and Eviction for Good Cause Ordinance, Section 12.i.
- [2] Regulations 1262 ff.
- [3] There is a substantial body of law relating to fair return in the public utility context, but there are major differences between regulated housing and public utilities, and courts have often declined to apply public utility law to rent control cases.
- [4] Birkenfeld et al v. City of Berkeley, 17 Cal. 3d 129 at 165.
- [5] Oceanside Mobilehome Park Owners' Association v. City of Oceanside, 157 Cal. App. 3d 887 at 903.
- [6] Cotati Alliance for Better Housing v. City of Cotati (1983) 148 Cal.App.3d 280.
- [7] Alexandra Fisher et al v. City of Berkeley (1985)
- [8] Measure I (Ordinance 5109-N.S.), Section 12.
- [9] Ira S. Lowry, Carol E. Hillestad, & Syam Sarma, "California's Housing - Adequacy, Availability, & Affordability," The Rand Corporation (1983), Santa Monica, CA, hereinafter referred to as "the Rand report", or simply as "Rand".
- [10] Rand, Table C.9.
- [11] Rand, Table C.7.
- [12] Estimate by the Institute of Real Estate Management (IREM).
- [13] Ken Baar and Richard Legates, in a 1984 report titled "Rental Housing Under the Berkeley Rent Stabilization Ordinance: A Survey of Tenants and Landlords", estimate the Proposition 13 tax decrease as 7% of gross rents (footnote 4, page 3), but there are no details allowing comparison of their method of calculation.
- [14] Ordinance 5212, Section 7.b.
- [14a] $4.8 \times 4 / 12 = 1.6$
- [15] Memorandum, dated 10/19/82 from Natalie West, City Attorney, to Jacqueline Foster, Rent Board Program Chief, titled "Indexing of Annual General Adjustment".
- [16] More precisely, the 1981 AGA allowed 5% for owners generally, but 6.2% for owners who supplied space heating to their tenants. The 1982 AGA allowed 9% for all owners, and in addition allowed a flat charge in varying amount for owners paid the costs of space heating.

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[23a] See Baar, "Guidelines for Drafting Rent Control Laws: Lessons of a Decade" (1983), 35 Rutgers Law Review 723.

[24] The return on value system, much discussed in court decisions,

suffers from computational difficulties which result in its having a circular effect: controlled rents determine value which in turn determines controlled rents.

The maintenance of net operating income system has been adopted in a number of California communities, and in some east coast cities. There is a distinction often missed, however. The east coast cities which use a net operating income guide allow the base year NOI to be indexed at the inflation rate. The standard is then more properly termed "maintenance of real net operating income". Berkeley's standard should be termed "maintenance of dollar net operating income" to make the distinction clear.

[25] The December 1978 CPI-U was 200.8. The December 1984 CPI-U was 325.8.

[26] Cotati , op. cit., p. 21.

[27] Fisher , op. cit., p. 63. The Fisher decision uses the word "profits" to mean "net operating income". In fact, net operating income has little to do with profits, a much more complex concept.

[28] Regulation 1262(A): "The net operating income ... which was produced by a property during the base year shall be presumed to provide the landlord ... with at least a fair return on investment."

[29] A recent decision on appeal said that "... to grant the landlord a 1262-C adjustment simply because the rent was lower [than other units in the building] would emasculate the regulation and the whole concept of the lawful base rent as a starting place to determine the current allowable maximum lawful rent ... and subverts the ordinance's purposes of stabilizing rent levels."

[30] Specific citation is being researched.

[31] Whether actual rents have increased by this figure is not so clear. A CHRI study now in process indicates that a substantial group of owners have not taken the legal increases. Another substantial group has taken increases which appear to exceed the legal maximums. A third group has had their otherwise legal rent ceiling reduced by action of the Board, in response to one or another infraction, some substantive, some merely technical.

[32] Rand, Table 4.4 and Table C.1.

[33] June 1978 CPI = 199.3 Dec 1984 CPI = 325.8
June 1978 Rents = 100 Dec 1984 Rents = 122.4
 $199.3 / 325.8 \times 122.4 = 74.875$.

[34] See Section 2.4 above for assumptions leading to these figures.

[35] The Baar Reports have never commented on prior year

calculations. Implicitly, however, staff and consultants have accepted the prior year rent increases as being cost-compensating, this principle being often alluded to in publications and communications of the Board.

[36] See Section 2.5 above for citations.

[37] Fisher , op. cit., p. 63.

CALIFORNIA HOUSING RESEARCH INSTITUTE

The California Housing Research Institute (CHRI) was founded in mid-1984 to study, and to promote public understanding of, public policy concerning housing. The founding members and the Board of Directors intend that the institute will make meaningful contributions to the current debates about the affordability and availability of housing in California. A particular concern of the institute at the present time involves policies and programs by which local governments regulate the price of housing services in the rental housing industry.

CHRI research services are available to groups and individuals wishing to sponsor research into housing issues. In general, completed CHRI research reports are available, at cost, to the public. Research reports do not necessarily reflect the views of the Board, the institute, or its sponsors. The work of the institute is made possible by research contracts for specific projects, and by donations. Tax-exempt contributions are gratefully received at CHRI's main office, 1900 Mountain Blvd., Oakland, CA 94611.

This study was written by Michael St. John, Research Director, CHRI, in consultation with members of the board. An economist specializing in regulation of industry, Mr. St. John's experience includes two years on the Rent Stabilization Board in Berkeley and two years as a consultant on rent control matters. Copies of this report may be secured by sending \$5.00 to CHRI at the above address.

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